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No. 80-84

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ANDERSON BROS. FORD and
FORD MOTOR CREDIT COMPANY,

Petitioners,

vs.

OLGA VALENCIA and
MIGUEL GONZALEZ,

Respondents.

PETITIONERS' REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Petitioners, ANDERSON BROS. FORD and FORD MOTOR CREDIT COMPANY ("Ford Credit"), submit this reply to bring to the Court's attention new authority from the Federal Reserve Board and to respond to certain new matters raised by respondents.

This case involves two critically important issues under the Truth in Lending Act (the "Act") on which there are clear conflicts among the Circuit Courts of Appeals. The first issue (discussed below in Point I) is whether an assignment of unearned insurance premiums needs to be disclosed as a security interest under the Act. A recently proposed Official Staff Interpretation of the Federal Reserve Board —issued after the Petition herein was filed—squarely answers that question in the negative. The second issue (discussed below in Point II) is whether a creditor's debt collection claim is a compulsory counterclaim in an action brought under the Act.

Because these issues are of great importance to the operation of the Act, and because of the severe conflict among the Circuits with respect to each, petitioners ask the Court to grant a writ of certiorari in this case to resolve both issues. Alternatively, at the very least, this cause should be remanded to the Court of Appeals for the Seventh Circuit for reconsideration of the first issue in light of the Federal Reserve Board's proposed Official Staff Interpretation which was issued after the court below had rendered its opinion. Petitioners submit, however, that these issues are ripe for resolution by this Court and that the interests of judicial economy can best be served by resolving both at this time.

I. There is a Direct Conflict Among the Circuits on the Security Interest Disclosure Issue which May be Resolved by Imminent Federal Reserve Board Action.

There is a direct and irreconcilable conflict among the Circuits over whether the assignment of unearned insurance premiums must be disclosed as a security interest under the Act. (Pet. 8-11).[1] The Tenth Circuit has ruled that the assignment of unearned insurance premiums need not be disclosed as a security interest.[2] The Fifth, Seventh, and Eighth Circuits, under a most technical reading of the Act, have ruled to the contrary in construing identical contract forms prepared by Ford Credit.[3]

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[1] The Petition for a Writ of Certiorari is cited hereafter as "Pet."; its Appendix is cited as "Pet. App." The Respondents' Brief in Opposition is cited hereafter as "Resp. Br."; its Appendix is cited as "Resp. Br. App."

[2] *James* v. *Ford Motor Credit Co.*, No. 78-1806 (10th Cir. June 24, 1980) (Pet. App. 48-58), *reh. denied* (10th Cir. July 21, 1980) (Resp. Br. App. 14-15).

[3] The opinion below; *Edmondson* v. *Allen-Russell Ford, Inc.*, 577 F.2d 291 (5th Cir. 1978), *cert. denied*, 441 U.S. 951 (1979) (Mr. Justice White voting in favor of granting the Writ); and *Murphy* v. *Ford Motor Credit Co.*, No. 79-1822 (8th Cir. August 28, 1980) (Resp. Br. App. 1-13). *See also Gennuso* v. *Commercial Bank & Trust Co.*, 566 F.2d 437 (3d Cir. 1977).

The Legislative Intent

Respondents cannot and do not deny the existence of this conflict. They simply assert that the Tenth Circuit erred by applying the Truth in Lending Simplification and Reform Act[4] (the "Simplification Act") to a case involving a contract executed before the effective date of the new law. (Resp. Br. 5-6). Respondents have misconstrued the decision of the Tenth Circuit. The Tenth Circuit did not apply the Simplification Act to the pending dispute; rather, it looked to the legislative history of the Simplification Act as an aid in determining the meaning of the present Act. In denying rehearing in *James,* the Tenth Circuit noted this Court's repeated recognition that " 'subsequent legislation reflecting an interpretation of an earlier Act is entitled to great weight in determining the meaning of the earlier statute.' " *Regents of the University of California* v. *Bakke,* 438 U.S. 265, 349 (1978). (Resp. Br. App. 15). The legislative history of the Simplification Act explicitly states that the security interest disclosure requirement was intended *not* to require the disclosure of "incidental interests" such as an assignment of unearned insurance premiums.[5] After analyzing the legislative history of the Simplification Act, the Tenth Circuit concluded:

> We are convinced that the 1980 Act reflects an interpretation by Congress of the earlier act and is entitled to great weight. The effect is that Congress in passing the 1968 Act did not intend to impose a civil penalty for the type of nondisclosure claimed by the appellants. (Resp. Br. App. 15).

The Tenth Circuit's interpretation of the Act is explicitly supported by the legislative history of the Simplification Act. Senator Garn, one of the principal authors of the

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[4] Truth in Lending Simplification and Reform Act, P.L. 96-221, Title VI, 94 Stat. 168.

[5] Report of the Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 96-368, 96th Cong., 1st Sess. 30 (1979), *reprinted in* [1980] U.S. Code Cong. & Adm. News 834, 864 (May 1980 Supp.).

Simplification Act, specifically indicated that the amendments merely clarified existing law:

> Many cases have resulted from the complex security interest disclosure requirements under the law. An illustrative case is *Gennuso* v. *Commercial Bank and Trust Company,* 455 F.Supp. 461 (W.D. Pa. 1976); 566 F.2d 437, (3rd Cir. 1977), which required the creditor's right in property insurance proceeds and unearned insurance premiums to be disclosed as a "security interest". *Although as presently written the law does not require that result, S. 108 should prevent such ludicrous interpretations* by requiring merely a positive indication if a security interest is being taken in the property purchased and if it is in property not being purchased in the transaction, simply a general listing of the type of property without a listing of incidental related interests. [Emphasis added.] 125 Cong. Rec. S.4990 (daily ed. May 1, 1979).

As described in the Petition for a Writ of Certiorari (Pet. 11-13), Congress was critical of the "highly technical judicial decisions" which have subverted the original purpose of the Act and have compelled creditors to issue lengthy disclosure statements "written in legalistic fine print . . . instead of the simple, concise disclosure form Congress intended."[6] Thus, the Simplification Act was enacted at least in part to correct judicial decisions that Congress believed had misinterpreted the original Act.

Federal Reserve Board Action

The Federal Reserve Board also has recently acted to resolve this question by issuing a proposed Official Staff Interpretation *under the current Act* which holds, in accordance with petitioners' position below, that the assignment of unearned insurance premiums is *not* a Truth in Lending Act security interest requiring disclosure. Pro-

[6] Report of the Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 96-73, 96th Cong., 1st Sess. 2-3 (1979), *reprinted in* [1980] U.S. Code Cong. & Adm. News 878, 879-880 (May 1980 Supp.).

posed Official Staff Interpretation FC-0173 (September 18, 1980) is attached hereto as a supplemental appendix. (Supp. App. 1-4). Recognizing that its interpretation is directly contrary to several Circuit Court decisions, the Federal Reserve Board Staff stated that this interpretation better serves the purposes of the Act:

> The staff believes that *a creditor is not required* by this section [Regulation Z, 12 C.F.R. § 226.8(b)(5) (1980)] *to disclose its right to receive insurance proceeds or unearned insurance premiums* nor to disclose that it is named as loss payee or beneficiary on an insurance policy. Truth in Lending disclosures are meant to provide useful information to consumers to enhance credit shopping. Consumers do need to know that they risk the loss of certain property if they default. The disclosures under § 226.8(b)(5) inform consumers of which property is subject to that risk at the time the credit decision is being made. We believe that information regarding the creditor's interest in insurance proceeds and unearned premiums would not be used in comparison shopping. Although a technical reading of the security interest definition might cover a creditor's interest in insurance proceeds and unearned premiums, it is our opinion that such incidental interests are not the type of interests meant to be covered by § 226.8(b)(5).
>
> The staff recognizes that there are a number of circuit court decisions to the contrary. We believe, however, that our position better serves the purpose of the statute and the regulation to convey in a meaningful way information that can be used by consumers in shopping for credit. [Emphasis added.] (Supp. App. 3).

The Federal Reserve Board's interpretation of the Act and Regulation Z is entitled to great deference. This Court recently stated in *Ford Motor Credit Company* v. *Milhollin*, 444 U.S. 555, 565-68 (1980):

> [D]eference [to the views of the administrative entity appointed to apply and enforce a statute] is especially appropriate in the process of interpreting the Truth in

> Lending Act and Regulation Z. Unless demonstrably irrational, *Federal Reserve Board staff opinions construing the Act or Regulation should be dispositive* for several reasons . . .
>
> • • •
>
> The Act is best construed by those who gave it substance in promulgating regulations thereunder.
>
> Furthermore, Congress has specifically designated the Federal Reserve Board and staff as the primary source for interpretation and application of truth in lending law . . .
>
> • • •
>
> Finally, wholly apart from jurisprudential considerations or congressional intent, deference to the Federal Reserve is compelled by necessity; a court that tries to chart a true course to the Act's purpose embarks upon a voyage without a compass when it disregards the agency's views. [Emphasis added.]

Spurred by the conflicting judicial interpretations of its own Regulation Z under the current Act, the Federal Reserve Board has thus taken a dramatic step to resolve this controversy. The importance of the Board Staff's interpretation (assuming that it is adopted as proposed) is further underscored by the fact that it will represent the first occasion during the eleven year history of the Act that the Board has taken a position squarely contrary to a prior decision thereunder by a federal Court of Appeals.

Impact of the Decision Below

Respondents contend that the decision below will have little impact on the credit industry because the Simplification Act will correct the problem. (Resp. Br. 2-4). Although it is true that the security interest disclosure issue will be resolved when the Simplification Act becomes effective in 1982, or possibly at an earlier date when proposed Official Staff Interpretation FC-0173 is adopted, this Court should not ignore the staggering volume of transactions that have

been and will be subject to attack before such actions can become effective. As of the date this Petition was filed, there were 91 cases pending against Ford Credit alone (including one class action) raising the issue decided below, and thousands of additional credit transactions will be entered into before either the Simplification Act or the proposed Federal Reserve Board interpretation becomes effective. There is no reason to leave the credit industry adrift in a sea of conflicting precedents any longer. By taking this case for review, this Court can easily dispose of the security interest disclosure issue which has divided the Circuits. On the other hand, the interests of judicial economy would not be served, and the credit industry would face additional litigation and uncertainty, if this Court were to leave the resolution of this issue to future cases to be decided in the various Circuits.

Respondents also assert that this case lacks importance because Ford Credit has changed its standard form of contract. (Resp. Br. 4). Respondents fail to mention that Ford Credit has done so by eliminating—because of the dramatic exposure presented by the uncertainty of this issue in the courts—the substantive provision in the former contract by which unearned premiums on physical damage insurance were assigned to Ford Credit. The purpose of the assignment provision was to assure the continued existence of the insurance on the vehicle during the life of the loan. (Pet. 4). Without such assignment, debtors can now cancel insurance on financed vehicles in order to obtain the return of unearned insurance premiums, thereby causing lenders to lose insurance protection on the real "security" for such loans, *i.e.*, the financed vehicles themselves. Thus, the conflicting judicial decisions on this issue have had the effect—never intended by Congress—of forcing creditors to eliminate a perfectly lawful contractual provision in order to avoid the potentially enormous liability under the Act for not properly disclosing such provision.

II. There is a Direct Conflict Among the Circuits on the Compulsory Counterclaim Issue.

Respondents make the incredible argument that there is no split among the Circuits on the compulsory counterclaim issue. (Resp. Br. 14). However, the recent decisions of the Fourth, Fifth and Seventh Circuits are in direct and irreconcilable conflict on this question. In *Plant* v. *Blazer Financial Services, Inc.*, 598 F.2d 1357 (5th Cir.), *reh. denied*, 605 F.2d 555 (5th Cir. 1979), the Fifth Circuit held that a creditor's debt collection counterclaim is compulsory under Rule 13(a) in an action brought under the Truth in Lending Act arising out of the same loan transaction. The Fourth Circuit held the exact opposite in *Whigham* v. *Beneficial Finance Co.*, 599 F.2d 1322 (4th Cir. 1979). In the decision below, the Seventh Circuit expressly noted the existence of "a conflict between the Fourth and Fifth Circuits on this issue." (Pet. App. 21).

Respondents attempt to reconcile this conflict by constructing a "numerosity" test to determine whether a counterclaim is compulsory. According to respondents, a debt collection counterclaim in a Truth in Lending action sometimes is and sometimes is not compulsory, depending on the number of additional issues which it raises. (Resp. Br. 14). Respondents' argument is both ingenious and disingenuous. There is nothing in the Fifth Circuit's decision in *Plant* which suggests that its holding is limited to "simple" debt collection counterclaims, nor is there any indication in the contrary decisions of the Fourth and Seventh Circuits that their holdings are limited to debt collection counterclaims that raise numerous additional issues. The Seventh Circuit in the decision below made no attempt to distinguish *Plant* on the basis of how many new issues are presented by a counterclaim; instead, the Seventh Circuit squarely rejected, on purported public policy grounds, the Fifth Circuit's analysis. (Pet. App. 23).

Moreover, the "numerosity" test proposed by respondents is completely unworkable. Under that test, a creditor sued

by a debtor in a Truth in Lending action in federal court could not know with any degree of certainty whether he was *required* to bring his debt collection claim as a compulsory counterclaim or whether he was *forbidden* to assert such claim in federal court because the court lacked jurisdiction over it. A creditor who guessed incorrectly and filed his debt collection claim in the wrong court would, at best, incur unnecessary legal expense and, at worst, risk being barred by Rule 13(a) or by the statute of limitations from ever asserting his claim. Only a decision by this Court can resolve the conflict and dispel the uncertainty which now pervades this area of the law.

Respondents devote most of their brief to arguing the merits of their position that two separate lawsuits are required (when one would suffice) to resolve the state and federal claims arising out of exactly the same transaction. Their main argument is that the counterclaim filed herein by Ford Credit presents "issues of fact and state law . . . which are wholly unrelated to respondents' TILA claim." (Resp. Br. 12). Respondents greatly exaggerate both the number of issues raised by the counterclaim and the difficulty of such issues. The counterclaim alleges a garden-variety breach of contract, and most of the elements of that cause of action—including execution of the contract and failure to make any of the payments due under the contract—are undisputed. In effect, respondents are seeking to create a special exception to Rule 13(a) applicable to certain debt collection counterclaims brought in Truth in Lending actions. Yet, in cases brought under federal remedial statutes, such as the antitrust laws, the courts have allowed the assertion of state law counterclaims in which the elements to be proved differed from those to be proved under the federal statutes. *See, e.g., Moore* v. *New York Cotton Exchange,* 270 U.S. 593 (1926); *City of Cleveland* v. *Cleveland Elec. Illuminating Co.,* 570 F.2d 123 (6th Cir. 1978). The same result should be reached here.

In sum, Congress did not intend that defaulting debtors should have one "free shot" at their creditors under the

Truth In Lending Act. The Act does not include any prohibition against the collection of the full amount of the underlying debt or interest thereon when a disclosure violation is discovered. The court below simply adopted a public policy concerning debt collection counterclaims in Truth in Lending suits which Congress never had in mind, and it is this policy which lies at the heart of the conflict with the Fifth Circuit's decision in *Plant*. Only action by this Court can resolve this fundamental conflict.

CONCLUSION

This case presents two issues involving direct conflicts among the Circuit Courts of Appeals which are of great importance to the credit industry and to the operation of the Act. Each of these issues is ripe for resolution by this Court, and petitioners request the Court to grant the Petition for a Writ of Certiorari and resolve both issues. In the event that this Court decides not to review this case on the merits at this time, petitioners urge that the judgment below be vacated and the case remanded to the Court of Appeals for the Seventh Circuit for reconsideration in light of the Federal Reserve Board's proposed Official Staff Interpretation which was issued after the decision below had been rendered.

Respectfully submitted,

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October 3, 1980

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; FC-0173]

TRUTH IN LENDING

Proposed Official Staff Interpretation

AGENCY:

Board of Governors of the Federal Reserve System.

ACTION:

Proposed official staff interpretation.

SUMMARY:

In accordance with 12 CFR 226.1(d)(2), the Board staff is publishing for comment official staff interpretation FC-0173 of Regulation Z, Truth in Lending, regarding security interest disclosures in closed end credit transactions. The proposed interpretation holds that a creditor need not disclose as a security interest its right to receive insurance proceeds or unearned premiums nor does it need to disclose that it is named as loss payee or beneficiary on an insurance policy.

DATES:

Comments must be received on or before October 20, 1980.

ADDRESS:

Comments (including reference to FC-0173) may be mailed to Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and Constitution Avenue, N.W., Wash-

ington, D.C. between 8:45 a.m. and 5:15 p.m. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT:

Claudia J. Yarus, Staff Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-3667).

SUPPLEMENTARY INFORMATION:

(1) The text of official staff interpretation FC-0173 is published with identifying details deleted to the extent required to prevent a clearly unwarranted invasion of personal privacy. The Board maintains and makes available for public inspection and copying a current index providing identifying information for the public, subject to certain limitations stated in 12 CFR Part 261.6.

(2) The letter is being issued as a proposal, rather than in final form, and interested persons are invited to submit relevant comment.

(3) After comments are considered, this official staff interpretation may be amended, may be withdrawn or may remain unchanged. Final action regarding this official staff interpretation will appear in the *Federal Register.*

(4) Authority: 15 U.S.C. 1640(f).

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§ 226.2(gg) Creditor is not required to disclose as a security interest its right to receive insurance proceeds or unearned insurance premiums nor to disclose that it is named as loss payee or beneficiary on an insurance policy.

§ 226.8(b)(5) " " "

This is in response to your letter requesting an official staff interpretation regarding security interest disclosures under § 226.8(b)(5) of Regulation Z. You wish to know

whether the creditor's right to receive proceeds or unearned premiums from a property or a credit life insurance policy must be disclosed as a security interest. You also ask if a security interest should be disclosed where a creditor requires that it be named as the loss payee on a property insurance policy or as the beneficiary on a credit insurance policy.

Section 226.8(b)(5) addresses disclosure of security interests in other than open end credit transactions. It requires disclosure of the type of security interest taken and identification of the property to which that interest relates.

The staff believes that a creditor is not required by this section to disclose its right to receive insurance proceeds or unearned insurance premiums nor to disclose that it is named as loss payee or beneficiary on an insurance policy. Truth in Lending disclosures are meant to provide useful information to consumers to enhance credit shopping. Consumers do need to know that they risk the loss of certain property if they default. The disclosures under § 226.8(b)(5) inform consumers of which property is subject to that risk at the time the credit decision is being made. We believe that information regarding the creditor's interest in insurance proceeds and unearned premiums would not be used in comparison shopping. Although a technical reading of the security interest definition might cover a creditor's interest in insurance proceeds and unearned premiums, it is our opinion that such incidental interests are not the type of interests meant to be covered by § 226.8(b)(5).

The staff recognizes that there are a number of circuit court decisions to the contrary. We believe, however, that our position better serves the purpose of the statute and the regulation to convey in a meaningful way information that can be used by consumers in shopping for credit.

This is an official staff interpretation of Regulation Z, issued in accordance with § 226.1(d)(2). It is limited to the facts and issues discussed herein.

Sincerely,

JANET HART
Director

Board of Governors of the Federal Reserve System, September 18, 1980.

(signed) THEODORE E. ALLISON
Theodore E. Allison
Secretary of the Board

[SEAL]